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The ‘Source’ of the International Tax Conundrum

Scott Wilkie (Osgoode Hall Law School) · Monday, February 10th, 2020

This is not a technical commentary. It does not react to a ‘new’ development or case. But these comments do try to focus on understated rudiments of the present international tax debate which may not have received the focus and direct unvarnished attention they deserve.[1]

We would do well to remember, as we seek solutions for the perceived incapacity of the international tax ‘system’ to deal with challenges closely associated with although notably not confined to ‘digital’ modalities of business, that the current debate about the allocation of taxing rights among countries and more broadly countries’ entitlement to tax, now supported by two ‘Pillars’ and reflected by an acronym – ‘GloBE’ – that oddly enough is also a pun for the ‘global’ debate, had simple beginnings and has simple undercurrents.

A mathematics metaphor is not out of place. My mathematics teachers admonished us to know what we were solving for, before selecting the technique that enabled the solution process. Understand the theorem before deriving or selecting the equation.

What are we solving for? Despite the cacophony of proposals, rebuttals and comments that dominate the current discussion about the inadequacies of familiar though necessarily imperfect markers of tax jurisdiction, there are only two variables in the international tax system equation. The solution, if there is one, does not require a new kind of mathematics, a new theorem as it were. It only requires that we understand the problem we have by way of its origins enough to know ‘what we are solving for’ and to know that advanced calculus is not required.

Fundamentally, there are two issues.

The first is whether and to what extent countries are to be permitted to advance their economic and fiscal interests by way effectively of what amount to co-investments in their taxpayers’ businesses and the transactions they implement, via ‘tax expenditures’. This issue, at its core a (tax) sovereignty issue, is most closely associated at present with the OECD Pillar Two proposal. Accepting that all of this, whatever ‘this’ is, needs to take place within the framework of a reliable legal system – the alternative is chaos – and that taxation is accessory to it, neither of which is a novel proposition although some of the current discussion seems challenging in this light, are countries entitled to fund, to subsidize, to invest in their economic well being enabled by features of their tax systems despite the inevitable influences of ‘multilateralism’ as it takes many economic and other guises? It’s a straightforward enough question – but not one easily addressed by ‘tax technology’. Inevitably, any response to this question must derive from countries’ fiscal choices and economic circumstances, which in turn reflect social, political and economic views closely

identified with collective consumption of public goods and services and, more generally, the features of civil society in the country. That is not to say that part of that civility does not entail looking out for others even beyond a country's borders, but there is no escaping the fundamental fiscal undercurrents of the present international tax discussion.

But, it seems, we do not want to confront these fiscal undercurrents. We have branded them with the unflattering critical epithet 'tax competition' and sidestepped the direct discussions about this key feature of international tax dynamics that may be enabled by the tax mechanics of which we mostly speak. Underlying, however, are questions of sovereignty and purposeful mutual accommodations, extending well beyond tax mechanics. In the late 1990s, under the guidance of the OECD, we ostensibly began to confront 'tax competition' but for various reasons that initiative was transformed into a program or work mostly concerned with information exchange, reporting and transparency – worthy objectives but not the same thing. Nowhere in the BEPS project or its spawn is paid direct, unvarnished attention to this subject, though 'tax competition' in its rawest and untested form is taken for granted, perhaps, to be a 'bad' feature of international relations – as if international tax as a discipline had significance apart from being a servant of fiscal policy. It therefore is axiomatic with tax base shifting, a notion that itself presumes primary tax base entitlements, on some basis, of countries from or with reference to which the base has been 'shifted'. Back to the math analogy: what is the universal comparator? Answer: there is none, or at least none that we know that is universal and would be incontrovertibly reliable in scientific way. This admission, though obscured by the dense language of committee reporting, is a notable concession to be found in the Action 11 Report. In other words, and to distill many words into a few, we don't really know what base erosion is – partly because perspective, that is national fiscal perspective, matters and that, of course is not universal but is as unique as there are many countries whose resources and senses and manifestations of national personality are different. And, even if somehow, we could know what, 'in principle', BEPS is, we are not well placed to measure it, reliably or even perhaps at all.

The second issue is more closely associated with the OECD Pillar One proposal, which at its core, like the BEPS exercise more generally, attempts to fashion a workable 'source' of income notion in that absence of that notion having intrinsic or universal defining characteristics. This issue concerns the marginal economic benefit that multinational enterprises can harvest by being multinational enterprises – its identification, measurement and allocation or attribution among legally distinct constituents of a multinational enterprise — a multinational business the economic unity of which is parsed by a variety of legal constructions. This, what the economists refer to as 'rent' or 'super rent' is not a new or mysterious notion. The mysterious part is, 'who' gets it?

We did confront this in the late 2000s in two connected ways. We examined 'business restructurings', to yield new or restated transfer pricing guidance directed to business reorganizations that had the intentional effect of 're'sourcing income. And we studied 'intangibles' of various kinds, not for their own sake but to appreciate the essential 'contributions' made by legally distinct fragments of the economic units called multinational enterprises in order to determine how the that marginal return should be shared among those fragments and therefore included in the tax bases of the countries where they resided. Two things are going on in this context. First, there is tacit but inevitable admission that business elements combine because they can make more income that way. And, second there is an equally tacit admission that despite the kind of fiscal and tax alchemy enabled by private law constructions, somehow all the fragments share the marginal benefit of 'togetherness' no matter how rudimentary and routine their direct contributions might be. In other words, there is a profitability 'delta' – which may be big or small,

that it would be something of a 'mugs game' to try on a scientific basis to attribute to any transactions or transactional elements given the nature of multinational enterprises. Much analysis has taken place, some of it very mathematical, to try to measure and assign that 'delta' although there is no universally accepted conclusion on this point, and none is expected soon.

Said a different way, this second issue concerns determining the 'source' of income. It is well trod ground to the conclusion that there is no 'natural' or universal notion of 'source'. Fundamentally it is a legal notion informed by economic and other evidence about the application of legal constructions to patterns of commercial and personal behavior. BEPS equally fundamentally, though not widely discussed in these terms, concerns the manipulation of those legal constructions – 'manipulation' without nefarious overtones or connotations – to change the source of income, or more affirmatively and positively perhaps to yield a clearly defined picture according to accepted legal conventions of what the source may be or, put differently, what it is not. That, stripped of many years of BEPS study, is the other shoe of BEPS; both, the 'tax competition', that is, 'tax expenditure' shoe and the 'sourcing' shoe are what are dropping now, in the two Pillars and GloBE proposals.

But still, we do not confront the rudiments of the BEPS equation, the two posited variables without which we cannot know 'what we are solving for': (1) 'aid' delivered through a tax regime by way of its systemic elements, which may or may not offend tenets of trade and competition regulation but are just as much subsidies as their more overt cousins that do more neatly fit WTO and EU anti-subsidy strictures of the WTO Agreements and the Treaty on the Functioning of the European Union; and (2) the inevitable frailty of thinking that there is a universal notion of source that is economic by design rather than description and that can easily be dropped into tax and legal systems of countries and their distinctive legal, fiscal and tax environments. We are consumed with technique in the present international tax conversation, which admits far too quickly the failure of familiar jurisdictional notions, and searches too hard for a 'theoretical' solution that does not think first about the practicalities of the problem.

Possibly, we need to recall the admonition of the math teacher: know what you are solving for – which requires us to admit that not irresponsibly countries enable, that is aid, themselves by aiding their taxpayers through systemic features of their tax regimes (about which there is controversy in trade and competition law circles), and that we do not really know what 'source' of income is of means. This drives us back to how the 'internationalization' of tax regimes in its 'modern' existence, emerging from the 1920s, first came about: avoid gratuitous, unintended interventions in trade among nations even then existing in a multilateral world, manifest in multiple taxation of the same persons or income, while nevertheless respecting nations' entitlements to determine and fund their economic destinies in their own images. As others have observed – notably Dani Rodrik at the Kennedy School of Government at Harvard University[2], the rush seemingly to merge regulatory regimes, including I would say tax regimes, because of the inertia of 'globalization' or more accurately perhaps 'multilateralism', takes place on a continuum: at one end are countries acting almost as if others did not exist, with limited kinds and degrees of interconnection, and at the other is effectively a merger of regimes. Presently, we seem to be at or thinking we need to head to the latter end of the spectrum; again as was the case from the late 1990s and 2000s, we explain this on the basis of transparent information exchange and global awareness of global commercial events despite their legal fragmentation in multinational enterprises.

The tension in the present debate, I would suggest, arises from not facing directly the practical implications of the two fundamental questions, about 'aid' (and inevitably sovereignty) and

'source' before first reaching for the box of tax technique. These issues are omnipresent in the current debate; they would be better faced head on. They are unavoidable. To that end, however, the suggestion in the Pillars and the GloBE proposal that a systematic, dare I say fractional or formulaic, approach might be the first best second best solution to the 'source' issue, and that economic welfare or enrichment that simply by observation arises from markets might justify a degree of minimum taxation by countries hosting the markets, project a good start to facing the hardest questions that underlie BEPS and its progeny.

These comments are personal and not to be attributed to any organization with which I am or have been associated.

[1] These comments distill, interpret and build on other similarly directed comments I have recently made in replying to the OECD's invitation for comments on the Two Pillars and GloBE proposals (published with the other public comment by the OECD) and in a recent edition of INTERTAX: J. Scott Wilkie, *The Way We Were? The Way We Must Be? The 'Arm's Length Principle' Sees Itself (for What It Is) in the 'Digital' Mirror*, INTERTAX, Volume 47, Issue 12, 1087 – 1102. Obviously, the references to 'Pillars' and 'GloBE' are to the well-known proposals disseminated by the OECD in 2019 to advance the OECD's continuing work arising from Base Erosion and Profit Shifting ('BEPS') project.

[2] See Dani Rodrik, *The Globalization Paradox, Democracy and the Future of the World Economy* (New York: S. W. Norton & Company, 2011), and Dani Rodrik, *Straight Talk on Trae, Ideas for a Sane World Economy* (Princeton an Oxford: Princeton University Press, 2018).

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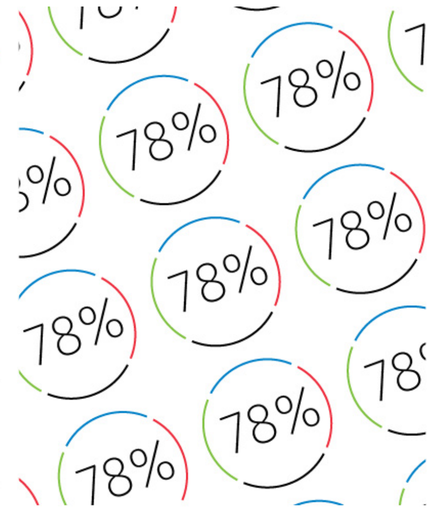

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